Internal Revenue Service
memorandum

CC:TL:Br2
JKHarris

date: DEC 2 2 1986

to: District Counsel, Birmingham CC:BIR

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

Your ref: CC:BIR:TL:FSimmons

This is in response to your request for technical advice dated October 15, 1986, in which you requested our views on the application of I.R.C. § 447, relating to methods of accounting for corporations engaged in farming.

ISSUE

Whether [redacted] ([redacted]) is a corporation under I.R.C. § 447(c), as a result of which its wholly-owned subsidiaries, [redacted], and [redacted], are required, beginning with the petitioner's fiscal year ended [redacted], to change their accounting method from cash receipts and disbursements to the accrual method, pursuant to section 447(a). 0447.00-00

CONCLUSION

[redacted] is required to utilize the accrual method of accounting for the taxable year at issue for the results of all its operations because it does not meet the exception provided in Code § 447(c)(2) for small businesses and family corporations where at least 50 percent of the corporation's stock is owned by members of the same family.

FACTS

[redacted] is a Delaware corporation that operates in Mississippi and other states; its principal place of business is [redacted], Mississippi. During its fiscal year ended [redacted], the tax year in issue, [redacted]'s principal shareholder was [redacted], who also served as president of the corporation.

During the fiscal year ended [redacted], [redacted] used the accrual method of accounting; two wholly-owned subsidiaries of [redacted], [redacted] and [redacted], used the cash method of accounting. [redacted] filed a consolidated return for the fiscal year ended [redacted]; [redacted], and [redacted] were included on the consolidated return filed by [redacted].

As of [redacted], the end of the fiscal year prior to the year at issue, [redacted] had total common stock outstanding, including options, of [redacted] shares; of this amount, [redacted] owned [redacted] shares or [redacted] percent.

As of [redacted], [redacted] also had outstanding [redacted] shares of preferred stock which was convertible to common stock at the rate of [redacted] shares of common for one share of preferred. All shares of preferred stock were owned by [redacted], an unrelated Corporation. In [redacted], [redacted] requested [redacted] to purchase the preferred stock. To this end, [redacted] agreed to purchase [redacted] shares of its preferred stock on [redacted]. In addition, [redacted] granted options to [redacted] to purchase [redacted] shares of its preferred stock twice per year in [redacted], [redacted] and [redacted], so that by [redacted], [redacted] would have purchased all [redacted] shares of the preferred stock held by [redacted] in [redacted].

On [redacted], [redacted] borrowed $[redacted] from [redacted], issuing a demand note in that amount to [redacted]. On [redacted], [redacted] assigned its right to purchase [redacted] shares of its preferred stock from [redacted] to [redacted]. On [redacted], [redacted] purchased the above-described [redacted] shares of [redacted] preferred stock from [redacted] with funds borrowed from [redacted]. Also on [redacted], [redacted] assigned to [redacted] its option to purchase [redacted] shares of its preferred stock from [redacted] on [redacted], and [redacted].

On [redacted], and [redacted], [redacted] exercised the above-described options assigned to him by [redacted] and on each date purchased an additional [redacted] shares of [redacted] preferred stock. The [redacted], purchase was funded by a loan from [redacted] to [redacted] in the amount of $[redacted], evidenced by a demand note from [redacted] to [redacted]. The [redacted], purchase was similarly funded by a loan from [redacted] to [redacted], evidenced by a demand note from [redacted] to [redacted] dated [redacted].

Accordingly, prior to the fiscal year in issue, [redacted] shares of [redacted] preferred stock, convertible to [redacted] shares of [redacted] stock was purchased from [redacted]. These purchases were made in the name of [redacted], but were funded with [redacted] corporate funds. In addition, the [redacted] shares of preferred stock were at all times during the fiscal year in question in [redacted]'s possession as collateral for its loans (totalling $[redacted]) to [redacted].

Therefore, during the fiscal year in issue, [redacted] had the following stock outstanding:

Common:		
Actual shares	[redacted]	
Options	[redacted]	
Total		[redacted]
Preferred	[redacted]	
Convertible to common at [redacted]	[redacted]	
Redeemed ([redacted] shares preferred, convertible to common at [redacted], purchased in [redacted] name)	[redacted]	
Outstanding		[redacted]
Total Outstanding		[redacted]

As noted above, at the end of the fiscal year prior to the fiscal year at issue, [redacted] owned [redacted] shares of the then-outstanding [redacted] shares of [redacted] common stock. [redacted] stock ownership represented [redacted] percent of [redacted]'s common stock.

At the close of the fiscal year at issue, as a result of the transactions described above, [redacted] had [redacted] shares of common stock outstanding. [redacted]' actual individual ownership of [redacted]'s common stock remained at [redacted] shares. Therefore, [redacted]'s actual percentage ownership of [redacted] common stock declined to approximately [redacted]%.

In years subsequent to the fiscal year at issue, [redacted] redeemed sufficient shares of the preferred stock acquired by [redacted] from [redacted] to enable [redacted] to liquidate his demand notes to [redacted].

DISCUSSION

I.R.C. § 447(a) provides, in pertinent part, that except as otherwise provided by law, the taxable income from farming of a corporation engaged in the trade or business of farming shall be computed on an accrual method of accounting.

Code § 447(c)(2) provides that for purposes of section 447(a), a corporation shall be treated as not being a corporation if it is a corporation of which at least 50 percent of the total combined voting power of all classes of stock entitled to vote, and at least 50 percent of the total number of shares of all other classes of stock of the corporation, are owned by members of the same family.

Code § 447(f) provides that in the case of any taxpayer required to change its method of accounting for any taxable year, such change shall be treated as having been made with the consent of the Secretary for purposes of Code § 481(a)(2), such change shall be treated as a change not initiated by the taxpayer, and the net amount of adjustments required by section 481(a) to be taken into account by the taxpayer in computing taxable income shall be taken into account in each, of the 10 taxable years beginning with the year of change.

Section 447 was added to the Code by section 204 of Public Law No. 94-455, the Tax Reform Act of 1976. The reasons for the addition of Code § 447 are set forth in H.R. Report No. 94-658, 94th Cong., 1st Sess., 93 (November 12, 1975), the Report of the Committee on Ways and Means. That Report states the following:

> Present law
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> Under the present law, a taxpayer engaged in farming activities may report the results of such activities for tax purposes on the cash method of accounting, regardless of whether the taxpayer is an individual, a corporation, a trust, or an estate.... the availability of the cash method for farmers contrasts with the tax rules which govern nonfarm taxpayers engaged in the business of selling products. Such nonfarm taxpayers must report their income using the accrual method of accounting and must accumulate their production costs in inventory until the product is sold. Under the accrual method of accounting as applied to farming, if crops are harvested and unsold at the end of the taxable year, the costs attributable to such crops cannot be deducted in the taxable year but must be treated as inventory. However, even under the accrual method, a farmer is permitted to deduct expenses paid in the taxable year so long as the crops to which these expenses relate are unharvested at the end of the taxable year. (I.T. 1368, I-1 C.B. 72 (1922).)
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> General reasons for change
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> Under the cash method of accounting, all items which constitute gross income are reported in the taxable year in which actually or constructively received, and expenses are deducted in the taxable

years in which they are actually paid. The primary advantage of the cash method is that it generally requires a minimum of recordkeeping; however, it frequently does not match income with related expenses. Consequently, the cash method can be used to create tax losses which defer current tax liabilities on both farm and nonfarm income. Corporations, as well as individuals, can benefit by the time value of such deferral of taxes.

The opportunity for farmers generally to use the cash method of accounting, without inventories and with current deduction of certain expenses which are properly capitalizable, was granted over 50 years ago by administrative rulings. These rulings were issued at a time when most agricultural operations were small operations carried on by individuals. The primary justification for the cash method of accounting for farm operations was its relative simplicity which, for example, eliminates the need to identify specific costs incurred in raising particular crops or animals.

In recent years, however, many corporations have entered farming. While some of these corporations involve relatively small business operations owned by a family or a few individuals, other corporations conduct large farm businesses which have ready access to the skilled accounting assistance often required to identify specific farm costs. In addition, sophisticated farm operations have often been carried on by farm syndicates or partnerships consisting of high-income investors and a corporation representing a promoter of a farm "tax shelter".

In view of this, your committee believes it is appropriate to require corporations, and certain partnerships, engaged in farming use an accrual method of accounting with the capitalization of certain pre-productive period expenses. Your committee, however, has excepted from this requirement certain small or family corporations in order to continue the cash basis method of accounting essentially for all those but the larger corporations engaged in farming.

Because there are no regulations, revenue rulings or litigated cases that address Code § 447, the above legislative history is the only source of guidance in interpreting this Code section. It seems clear from the Committee Report that the intent of Congress in enacting this provision was to require all corporations, other than small family corporations, to utilize the accrual method of accounting in order to more accruately reflect income and expenses. Congress did recognize, however, that small family corporations might not have access to the skilled accounting assistance that may be required for the accrual method of accounting. Therefore, Code § 447(c) excepts small family corporations from the mandated adoption of the accrual method of accounting. The legislative parameters provided in Code § 447(c)(2) 1/ are farming corporations that are owned to the extent of at least 50 percent of outstanding voting stock by members of the same family.

It also seems clear from the legislative history of Code § 447(f), relating to coordination with § 481, that Congress intended Code § 447 to be applied broadly to substantially all corporate entities engaged in farming. The 10-year spread of any mandated adjustment to income because of the imposition of an accrual method of accounting is a significant relief provision that indicates Congressional intent to reasonably ameliorate a sweeping change in accounting methods for farming corporations.

In the instant case, [redacted] was aware that the import of Code § 447 was a required conversion to the accrual method of accounting upon the enactment of the Tax Reform Act of 1976. [redacted] was also aware that the owner of all its convertible preferred stock had requested that such stock be repurchased. To avoid the application of Code § 447, to prevent the concentration of ownership of common stock by [redacted] from being diluted below 50 percent, [redacted] undertook a related series of transactions to have [redacted] purchase its convertible preferred stock. These transactions, described above, resulted in [redacted] using corporate funds to redeem its preferred convertible stock, but with such stock being held in the name of [redacted].

In determining whether a series of related transactions can be collapsed and viewed as a single, purposeful transaction, the courts use a variety of tests. Factors considered include the intent of the parties, the time frame involved, a pragmatic test of the ultimate result and mutual interdependence of the steps utilized. American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1948). The mutual interdependence test is viewed as crucial since it inquires whether a series of transactions were so dependent on one another that legal relations created by one transaction would not have been created without a completion of the intended series of transactions. American Bantam at 405. See also Ralph L. Evans v. Commissioner, 8 B.T.A. 543 (1927).

1/ The gross receipts exception of $[redacted] or less provided by Code §§ 447(c)(3) and 447(e) is not at issue in this case since [redacted] had gross receipts of $[redacted] in [redacted] and $[redacted] in [redacted].

In the instant case, applying the tests set forth by American Bantam, it is clear that [redacted] initiated the repurchase of its convertible preferred stock in the name of [redacted] to avoid application of Code § 447. This intent is further demonstrated by [redacted]'s assignment of its option to purchase its preferred stock to its principal shareholder and the making of loans sufficient to enable [redacted] to purchase the stock coincidentally with the date of the execution of the assigned options. The granting of the options and making of demand loans are also evidence of a series of transactions initiated within close proximity of each other to achieve a predetermined end result. The steps utilized by [redacted] are also mutally dependent in that the creation of substantially unsecured loans, in the amount of $[redacted], to [redacted] would not have been undertaken except as part of a series of transactions to secure the preferred stock and yet avoid Code § 447.

In John A. Hall v. Commissioner, T.C.M. 1983-140, the court concluded that a series of transactions between shareholders of a corporation was a redemption of shares essentially equivalent to a dividend. In Hall, the principal shareholder sold 30 shares of stock to another shareholder. On the same day, the corporation redeemed 30 shares of stock from the second shareholder for the same consideration.

The Court in Hall cited Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945), for the well-settled proposition that the "incidence of taxation depends upon the substance of a transaction" rather than mere form. The court further stated that "(c)ourts have frequently treated separate steps as part of a single transaction so as to elevate substance over form," citing Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942), and Kuper v. Commissioner, 535 F.2d 152 (5th Cir. 1942). The Court concluded that the steps in Hall were in reality one transaction whereby Hall's shares would be redeemed by the corporation.

CONCLUSION

Similarly, in [redacted] the series of transaction undertaken to repurchase the convertible preferred stock can be demonstrated to be a series of steps to avoid the application of Code § 447. Accordingly, [redacted] is a corporation for the fiscal year in issue within the meaning of Code § 447(c).

Sincerely,

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